



Willem H. Buiter

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Willem Buiter

**Transition and Sustainable Growth in the Early Transition Countries:
The Role of the Private Sector in Poverty Reduction**

**ETC Strategic Review Meeting
9.10 am Wednesday June 30, 2004**

The EBRD was created as a transition bank. It was thought, at the time of its creation, that the problems of former centrally planned economies were qualitatively different from those of the vast majority of developing countries and emerging markets. Transition countries were viewed as greatly distorted but rather advanced industrial societies. Human capital and infrastructure capital was of better quality and more abundant than in 'normal' developing countries. Poverty and policies to reduce or even eliminate poverty were not central to the mission of the EBRD as conceived at its creation. Indeed the words 'poverty' or 'poor', cannot be found in the Agreement Establishing the Bank.

We have learnt a lot since those days. Even in those countries of operations that turned out to be successful transition countries, especially those who recently joined the EU or are likely to join it soon, poverty has increased, even though average real per capita income now exceeds the levels of 1989, and so has economic inequality. In the less successful transition countries, poverty has increased significantly. In the least successful transition countries including our seven Early Transition Countries (ETCs), poverty has increased massively. It is now recognised that these countries face development challenges as well as transition challenges. Our Bank, to remain effective, will have to act like a development bank as well as a transition bank. Fortunately, its name allows that!

While in the ETCs the EBRD will have to become more of a development bank as well as a transition bank, we should not lose our greatest strength, which is our focus on strengthening the institutions that support an effective market economy through projects, mainly, although not exclusively, in the private sector. Without a dynamic, innovative private sector, economic development becomes social work and emergency relief – important and worthy tasks both, but not what is required to lift the vast majority of the population out of poverty on a sustainable basis.

So we keep on doing what we have been doing but with some key additions:

- We need vastly more grant money (donor funds) to fund Technical Assistance (TA) and Technical Cooperation (TC) for project preparation and capacity building.
- In our public sector, sovereign or sub-sovereign operations, we need additional concessional resources to blend with our own non-concessional resources to make the package affordable to cash-strapped, revenue constrained public sector borrowers.¹

¹ In recent years, countries with IMF programs and viewed as highly indebted by the IMF (defined operationally as having an external debt to exports ratio of 150% or more and an external debt to tax revenues ratio of 250% or more) could only take on additional public liabilities if the pure grant component of the incremental debt was at least 35%.

- In our private sector operations we need additional concessional resources to take the kind of risks that conventional sound banking practices would not permit us to take.

For transition economies, transition towards of market economy is part of the terrain – often difficult – that must be crossed on the road towards sustainable development. The point of departure for transition was communism and central planning – a system that was politically, economically, socially and environmentally unsustainable.

A market economy can deliver sustainable growth under the right conditions, but this is by no means automatic or assured; there are many examples of dysfunctional market economies that are mired in stagnation. It requires effective governance by state institutions as well as a competitive and dynamic private sector that has the confidence to invest in the future. The ticket to prosperity for most citizens is a job in the private sector, where most economic value is created – upwards of 70 per cent. This is not to deny the crucial roles that the public sector perform, but simply a description of the balance of economic activity between the public and private sectors in a market economy.

The early transition economies in which the EBRD operates have started their transition, but remain in some fairly rough terrain. In recent years, these countries have demonstrated their potential dynamism, registering relatively rapid growth rates in recent years. However, the confidence and dynamism of the private sector remains fragile.

The ETCs emerged from the former Soviet Union with a number of difficult legacies. All were faced with a triple transition challenge: (1) from central planning to a market economy; (2) from totalitarian communism to pluralistic, open, democratic forms of government; and (3) from colonial subjugation to independent nationhood and statehood. It is not surprising that none of the seven ETC countries has fully achieved more than one of these three transitions, and that some still have a long way to go on all three tracks.

They were all relatively poor within the Soviet Union and remain so today. Moldova will one day – soon I hope - be on the border of the expanded EU, but remains relatively closed in terms of trade, with negligible access to EU markets, especially to the markets for temperate zone agricultural products which are locked out by the Common Agricultural Policy. The Caucasus countries too may at some future date be on the border of the expanded EU, after Turkey becomes an EU member, but are quite far removed from the global economic centers of gravity at this time. The landlocked nations of the Caucasus and Central Asia are geographically remote and isolated. The governments of these newly independent states face many challenges in terms of the governance they provide and their ability to raise revenues for essential expenditures on public administration, infrastructure, public goods and services and the social safety net.

The initial lack of economic dynamism and states with limited ability to raise revenues resulted in heavy debt burdens in a number of the ETC – particularly in Georgia, the Kyrgyz Republic, Moldova, Tajikistan. Uzbekistan does not belong to the highly indebted category, but that situation could change quite quickly through

adverse terms of trade shocks and a sharp depreciation of the real exchange rate. The overhang of public external debt constrains the ability of many ETC governments to borrow on non-concessional terms. It also limits the private sector's ability to access international capital because of the high country risk.

The limited resources of the state, compounded by often poor governance, have left many institution building challenges unmet in the early transition countries. Institution building of course has many facets that relate to sustainable development. Clearly, systems for the provision of education and health care are central to sustainable development – they are necessary to develop the skills base of any economy. They are also desirable in their own right.

But the facets of institution building on which I would like to focus are those that are related to private sector development and in particular to the process of business investment and finance. This vital link between private sector development, the business environment and institution building on the one hand, and sustainable growth and poverty reduction on the other is central to the EBRD's approach to the early transition countries. It is also in this area that the EBRD can and should make a more significant contribution to the Poverty Reduction Strategy Papers (PRSPs) of the ETCs.

Past PRSPs, not just in our region but across the world have been thin on private sector issues, offering few specifics. The link between private sector development and poverty reduction, which should be central to the PRSPs, is inadequately recognised. The main 'mentoring' institutions for the PRSP process, especially the World Bank, have advised countries to spell out their policies on social expenditures in considerable detail. Concrete policies or action plans to improve the business environment and investment climate have not been routinely included in the PRSP. The private sector -- in particular potential entrants and SMEs -- have rarely participated effectively in producing these documents. While most of the 30 PRSPs cover private sector development, only very few spell out indicators through which progress could be monitored.

Despite these shortcomings of past PRSPs, these documents may still become an effective instrument through which these private sector elements are eventually incorporated in national policies. I understand that some TA is under way at the World Bank to develop capacity in this area and I propose that the EBRD gets involved in this in our countries of operation on a regular basis, rather than on an exceptional and ad-hoc basis as has been the case up till now. Greater coordination and cooperation between the Bretton Woods institutions and all the regional development banks is desirable. In the Feb 14, 2002 Review of the Poverty Reduction and Growth Facility: Issues and Options - a 24-page paper prepared by the IMF -, the EBRD is not mentioned (neither are any of the other regional Multilateral Development Banks). This reflects the reality of the EBRD's involvement up to that time, but it is not a reality that we wish to see perpetuated.

The EBRD's general approach has been to link its support for institution building through donor support to the Bank's investment operations in projects. This has been an effective combination – it helps to improve the quality of both the institution

building initiatives and the investment projects. However, in the ETC countries this approach is going to need more of kick start.

In our view, key areas for institution building will be: small business development, financial reform and development, infrastructure and energy, and governance and legal transition. Where the PRSPs of Early Transition Countries identify private sector development relevant institution building, they tend to focus on the same areas.

The challenges are many and manifest. So are the contributions each of our institutions and donor nations can make. So let's get on with the job.